MEMO# 15166

September 12, 2002

SEC ADMINISTRATIVE PROCEEDING REGARDING DISCLOSURE OF FUND'S INVESTMENT STRATEGY AND PERFORMANCE

[15166] September 12, 2002 TO: COMPLIANCE ADVISORY COMMITTEE No. 75-02 SEC RULES MEMBERS No. 76-02 RE: SEC ADMINISTRATIVE PROCEEDING REGARDING DISCLOSURE OF FUND'S INVESTMENT STRATEGY AND PERFORMANCE The Securities and Exchange Commission recently accepted an offer of settlement and imposed sanctions in an administrative proceeding involving an investment adviser in connection with disclosure of the investment strategy and performance of a fund subadvised by the adviser.* The adviser consented to the entry of an order, without admitting or denying the Commission's findings. The order is attached and is summarized below. The order states that the fund commenced operation in 1984 and had a stated investment objective of growth of capital, with a focus on small- to mid-cap companies. In 1999, the adviser became the subadviser to the fund. The order indicates that the adviser's head trader believed that it would be profitable to purchase shares of initial public offerings ("IPOs") and sell, or "flip," the shares on the same or next trading day. The order further states that, because of its belief that this IPO trading would be risky, the adviser limited the trader's discretion to trade IPOs in three respects: (1) the trader was allowed to only risk a small percentage of the fund's assets; (2) the trader was to invest in IPOs only when he believed that there would be significant post-IPO demand for the shares and that the IPO shares could be immediately sold for a profit; and (3) the trader was to sell promptly the IPO shares and to not allow the IPO shares to become long-term investments unless research by the adviser's personnel supported a longer holding period. The order states that the trader complied with these limitations. During 1999 and 2000, the trader invested in a total of 182 initial public offerings—90 in 1999 and 92 in 2000. The order indicates that the trader's average IPO investment during 1999 and 2000 represented approximately .047% and .046% of the fund's net asset value as of December 31, 1999 and December 31, 2000, respectively. In addition, the order states that, in the vast majority of instances, the trader flipped the IPO shares. On average, the fund held the IPO shares for less than 2.3 days. According to the order, the trading of IPOs had a significant effect on the fund's performance for 1999 and 2000. The order states that, in 1999 and 2000, the fund's net profit from IPO trading accounted for approximately 25% of the fund's 31.45% return, and 47% of the * In the Matter of Davis Selected Advisers-NY, Inc., Admin. Proc. File No. 3-10885 (September 4, 2002). A copy of the order is available on the Commission's website at www.sec.gov/litigation/admin/ia-2055.htm. 2 fund's 11.49% return, respectively. The order indicates that both the adviser and the trader were aware that the short-term IPO trading had a positive effect on the fund's performance. According

to the order, the adviser failed to disclose certain material information regarding its trading in IPOs for the fund and the effect of the trading on the fund's performance. In particular, the order states that the fund's disclosure documents described the fund's investment strategy as holding investments for the long term, but did not contain any specific disclosure regarding the adviser's short-term IPO trading for the fund. The order notes that the fund's 1999 and 2000 annual reports contained charts showing all of the fund's share purchases and sales (including the IPO shares), the date of the purchases and sales and the gain or loss on the sales, but states that the fund's disclosure documents did not identify any of the shares as IPO shares and did not discuss specifically the fund's trading in IPO shares. The order also states that the fund's disclosure documents did not disclose the overall effect of the fund's short-term trading in IPO shares on its periodic performance, despite the fact that the IPO flipping was not only a new technique that the fund was experimenting with, but also was easily isolated and separately identifiable from other performance factors. In particular, the fund's 1999 and 2000 annual reports did not state that (i) in 1999, the fund's short-term trading in IPOs of technology companies contributed substantially to the fund's performance and (ii) in 2000, the fund's short-term IPO trades both reduced the overall negative impact of the fund's technology investments and contributed significantly to the periodic performance of the fund as a whole. The Commission concluded that disclosure of the nature or extent of the fund's short- term IPO trading and the material impact that the short-term IPO trading had on the fund's performance would have been material to an investor's decision whether to invest in the fund, particularly because the short-term IPO trading had a significant impact on the fund's performance and such performance would probably not continue when there was a cooling in the IPO market or if the fund grew significantly. On this basis, the Commission found that the adviser willfully violated Section 34(b) of the Investment Company Act, which prohibits the filing, transmitting or keeping of certain documents that omit to state facts necessary in order to prevent the statements made in those documents, in the light of the circumstances under which they were made, from being materially misleading. The adviser was censured and ordered to cease and desist from committing or causing any violation and any future violation of Section 34(b) of the Investment Company Act and to pay a civil penalty of $10,000. Anu Dubey Assistant Counsel